Tax Policy
Concept Statement 1

Guiding Principles of Good Tax Policy:
A Framework for Evaluating Tax Proposals

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AICPA

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FOREWORD

This statement stems from a tax policy and reform project started in the mid-1990s on possible avenues for the AICPA to help shape and inform congressional tax reform activities underway at the time. Officially released in 2001, this was the first in a series of tax policy concept statements issued by the AICPA Tax Division on tax policy matters. It is intended to aid in the development and improvement of tax laws in directions that the AICPA believes are in the public interest.

Tax policy concept statements are approved by the Tax Executive Committee of the AICPA Tax Division after development by an assigned committee, technical resource panel, or task force.

This statement was originally developed by the Fundamental Tax Reform Task Force with input from the 1998-1999 Tax Policy and Simplification Committee and the 1999-2000 Tax Legislation and Policy Committee. It was approved by the 2000-01 Tax Legislation and Policy Committee and the 2000-01 Tax Executive Committee. The statement was updated in 2017 and approved by the 2016-17 Tax Executive Committee.

Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Rules and Proposals

OVERVIEW

Purpose of This Tax Policy Concept Statement

Discussions occur regularly among politicians, economists, tax practitioners, and others about changing national and subnational tax systems. Any suggestion for modifying tax rules – whether major or minor — raises the question of how to best analyze and compare proposals. A framework based on appropriate tax policies is needed to effectively analyze proposals to change tax rules and tax systems. Such a framework, based on widely-accepted principles, also provides an objective approach for evaluating and improving existing tax rules.

Guiding Principles of Good Tax Policy

The guiding principles, listed below, are commonly cited and used as indicators of good tax policy. The first four principles are the maxims of taxation laid out by economist Adam Smith in his 1776 work, *The Wealth of Nations*.[1] These principles, along with the additional eight, have been used for many years by governments, economists, tax advisers, and others.[2] The numbered order of the principles in this statement is for reference only and is not an indication of the order of importance of these principles.

1. *Equity and Fairness*. Similarly situated taxpayers should be taxed similarly.

2. *Certainty*. The tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made.

3. *Convenience of Payment*. Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important.

4. *Effective Tax Administration*. Costs to collect a tax should be kept to a minimum for both the government and taxpayers.

5. *Information Security*. Tax administration must protect taxpayer information from all forms of unintended and improper disclosure.

[1] Adam Smith, *The Wealth of Nations*, edited by Edwin Cannan, New York, The Modern Library, 1994, pages 887 to 890

[2] For example, per the OECD: "Assuming a certain level of revenue that needs to be raised, which depends on the broader economic and fiscal policies of the country concerned, there are a number of broad tax policy considerations that have traditionally guided the development of taxation systems. These include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility." OECD, *Addressing the Tax Challenge of the Digital Economy*, 2014, page 30.

6. *Simplicity*. Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

7. *Neutrality*. Minimizing the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction is important.

8. *Economic Growth and Efficiency*. The tax system should not unduly impede or reduce the productive capacity of the economy.

9. *Transparency and Visibility*. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

10. *Minimum Tax Gap*. Structuring tax laws to minimize noncompliance is essential.

11. *Accountability to Taxpayers*. Accessibility and visibility of information on tax laws and their development, modification and purpose, are necessary for taxpayers.

12. *Appropriate Government Revenues*. Tax systems should have appropriate levels of predictability, stability and reliability to enable the government to determine the timing and amount of tax collections.

Formulations of Principles of Good Tax Policy

The following table shows how the guiding principles correspond to commonly used formulations of criteria used to analyze tax systems.

AICPA Principles of Good Tax Policy	**OECD** Tax Principles	U.S. Joint Committee on Taxation (**JCT**) Analysis Criteria	U.S. Government Accountability Office (**GAO**) Criteria for a Good Tax System
Equity and fairness	See neutrality below.	Is "the tax system fair? Does the tax system treat similarly situated individuals similarly? Does the tax system account for individuals' different capacities to bear the burden of taxation?"	Equity includes two principles: (1) ability to pay (horizontal and vertical equity), and (2) benefits received. "When making judgments about the overall equity of government policy, it is important to consider both how individuals are taxed and how the benefits of government

			spending are distributed.”
Certainty	See simplicity below.		
Convenience of payment	“Compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.”		
Effective tax administration	See convenience of payment above.	“Can the tax system be easily administered by the government and can it induce compliance by all individuals? Is enforcement costly? Can some individuals successfully avoid their legal liabilities?”	Administrability including “processing returns, enforcement, and taxpayer assistance.”
Information security	Structural features should keep pace with technological changes.		
Simplicity	“The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.”	Is “the tax system simple? Is it costly for taxpayers to determine their tax liability and file their taxes?”	Simplicity in terms of the “compliance burden (record keeping, planning, return preparation, and responding to audits).”
Neutrality	“Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.”	See economic growth and efficiency below.	The system should not distort economic decisions.

Economic growth and efficiency	"The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments."	Does "the tax system promote or hinder economic efficiency? That is, to what extent does the tax system distort taxpayer behavior by imposing high marginal tax rates on labor, saving, or other activities? Does the tax system create a bias against the domestic production of goods and services? To what extent does it promote economic growth?"	Economic efficiency of tax changes should be considered.
Transparency and visibility			Transparency of "tax calculations, logic behind tax laws, tax burden and compliance."
Minimum tax gap	"The potential for tax evasion and avoidance should be minimized while keeping counteracting measures proportionate to the risks involved."	"Can some individuals successfully avoid their legal liabilities?"	
Accountability to taxpayers[3]			"Taxpayers understand the extent to which the tax laws are enforced."
Appropriate government revenues	"Taxation should produce the right amount of tax at the right time."		

[3] This principle ties to one of nine specified by the National Conference of State Legislatures (NCSL). This group's explanation of this principle states: "The essence of accountability is that tax laws should be explicit, not hidden. Proposals for changes should be well publicized to stimulate debate." National Conference of State Legislatures, *Principles of a High-Quality State Revenue System*, Fourth Edition, June 2007.

A more detailed explanation of each of the guiding principles is provided in the next section. Some of the challenges in following the principles are also described. Despite the challenges, proposals for changes to the tax law should strive to consider all guiding principles.

EXPLANATIONS OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY

Equity and Fairness

Similarly situated taxpayers should be taxed similarly. The principle of taxing similar taxpayers similarly is typically described in terms of *equity*. The concept of *horizontal equity* provides that two taxpayers with equal abilities to pay should pay the same amount of tax. If a taxpayer has a greater ability to pay than another taxpayer, the concept of *vertical equity* comes into play, which means that the person with the greater ability to pay should pay more tax. Of course, how much more tax to pay is a common topic of debate and, over the decades, has resulted in a variety of ranges of graduated tax rates and exemption amounts leading to varying levels of progressivity of the tax systems.

The principle of equity is often viewed as a fairness principle. That is, many people view a tax as fair if taxpayers with the greatest ability to pay have the highest tax burdens. Nevertheless, the term *fair* tends to have different meanings to different people. For example, with respect to an income tax, consideration of a fair income tax system might arise if —

1. All taxpayers are taxed at the same tax rate (a flat tax) because those with higher incomes will pay more than taxpayers with lower incomes.

2. Taxpayers with higher incomes pay tax at higher rates than lower income taxpayers (a progressive tax).

3. Many different types of income are taxed the same (meaning, for instance, that few or no types of income are excluded from taxation).

4. It combines the elements of items 1 and 3 above.

5. It combines the elements of items 2 and 3 above.

Therefore, use of the word *fair* in describing a tax is better used in the context of whether a tax system is *perceived* as fair. This approach acknowledges some of the subjectiveness of the term *fair*. Yet, as explained in the JCT and GAO reports, various measures exist to examine equity including distributional analyses of annual taxes, lifetime taxes, and more.

Generally, in evaluating the principle of *equity*, giving consideration to the entire range of taxes a taxpayer is subject to, rather than to just one type of tax, is a must.

Certainty

The tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made. Certainty, rather than ambiguity, of a person's tax liability is vital. The tax rules should specify the amount of the payment, when the tax is due, and how payment is made. A tax system's rules must enable taxpayers to determine what is subject to tax (the tax base) and at what tax rate(s). Taxpayers should have the ability to determine their tax liabilities with reasonable certainty based on the nature of their transactions. If the transactions subject to tax are easy to identify and value, the principle of certainty is more likely attained. On the other hand, if the tax base is dependent on subjective valuations or transactions that are difficult to categorize, attaining the principle of certainty might not happen. In addition, spelling out how the taxes are paid and when the taxes are due in the applicable laws, as well as in the tax forms and instructions, is essential.

Certainty is important to a tax system because it helps to improve compliance with the rules and to increase respect for the system. Certainty generally comes from clear statutes as well as timely and understandable administrative guidance that is readily available to taxpayers.

The principle of certainty is closely related to the principle of simplicity. The more complex the tax rules and system, the greater likelihood that the certainty principle is compromised.

Convenience of Payment

Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important. For example, assessment of tax upon the purchase of goods should occur at the time of purchase when the person still has the choice as to whether to buy the goods and pay the tax. Convenience of payment is important in helping to ensure compliance with the tax system. The more difficult a tax is to pay, the more likely that payment will not happen. Typical payment mechanisms include withholding (such as the withholding of income taxes from employee paychecks) and periodic payments of estimated tax liability. The appropriate payment mechanism should depend on the amount of the liability and ease of collection as well as the equity of collection from all taxpayers. Also, consideration of appropriate use of secure technology is important.

Effective Tax Administration

Costs to collect a tax should be kept to a minimum for both the government and taxpayers. Minimizing administrative and compliance costs is critical.[4] These costs include the administrative cost to the government that is influenced by the number of revenue officers necessary to administer the tax. Consideration of taxpayer compliance costs is also a must. This principle is closely related to the principle of simplicity. The more complex a tax, the greater the costs of government administration and the greater the compliance costs for taxpayers to determine and report their tax liability. Consideration of appropriate use of secure technology is also necessary. The benefits of any reform should outweigh the costs of adoption, including transitional and implementation costs.

[4] Adam Smith's maxims referred to this principle as "economy of collection."

Information Security

Tax administration must protect taxpayer information from all forms of unintended and improper disclosure. This includes, but is not limited to, adequate "firewalls" for security of the tax agency's internal system, safeguards necessary to prevent degradation of the system via fraudulent claims resulting from identity theft, as well as sufficient controls to ensure that taxpayer information is only disclosed to the appropriate parties as permitted by law. A tax administration's responsibility for information security should extend to its employees, representatives, agents, and any contracted or affiliated party. This protection must extend throughout the period the information is held, and must accommodate changes in technology and threats against the information. Failure to provide adequate security ultimately results in erosion of the principles of equity and fairness, effective tax administration, and appropriate government revenues.

Simplicity

Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner. Simplicity in the tax system is important both to taxpayers and tax administrators. Complex rules lead to errors and disrespect for the system that can reduce compliance. Simplicity is important both to improve the compliance process and to enable taxpayers to better understand the tax consequences of transactions in which they engage in or plan to engage.

Neutrality

Minimizing the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction is important. Minimizing the effect of the tax law on business and personal decisions is appropriate. The primary purpose of a tax is to raise revenue for governmental activities, rather than to influence business and personal decisions.

Economic Growth and Efficiency

The tax system should not unduly impede or reduce the productive capacity of the economy. All taxes reduce economic efficiency and create distortions, but good tax policy minimizes these effects. The tax system should not hinder a jurisdiction's economic goals, such as economic growth, capital formation, and international competitiveness. The principle of economic growth and efficiency is maximized by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax. For example, a jurisdiction's tax rules should not pose competitive disadvantages for firms resident in that jurisdiction relative to non-resident firms. Economic growth and efficiency is impeded by tax rules that favor a particular industry or investment, thereby causing capital and labor to flow to such areas for reasons not supported by economic factors. Such action can potentially harm other industries and investments, as well as the economy as a whole.

The principle of economic growth and efficiency is related to the principle of neutrality in that tax rules that distort taxpayer behavior may hinder economic efficiency. Evaluating a potential tax structure with respect to neutrality between different forms of business activities to ensure that the enactment would not result in discrimination in favor or against particular ways of doing business is vital.

Transparency and Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others. Visibility enables individuals and businesses to know the true cost of transactions. It also enables them to see what their total tax liability is and to which level of government it is being paid. When a tax is not visible, it is easily retained or raised with little, if any, awareness among taxpayers about how the tax affects them.

Minimum Tax Gap

Structuring tax laws to minimize noncompliance is essential. The *tax gap* is the difference between taxes that are owed and taxes that are voluntarily paid. A tax gap exists with any tax for a variety of reasons, such as intentional errors (non-filing, underreporting of income, overstating of deductions, and omission of transactions) and unintentional errors (math mistakes and lack of understanding of the rules). Complex tax provisions can lead to noncompliance due to errors caused by confusion and uncertainty. Procedural rules are generally required for all tax systems to encourage compliance. Rules to encourage compliance might include mandatory withholding of taxes at the source and penalties for noncompliance. Generally, compliance measures need to strike a balance between the desired level of compliance against the costs of enforcement and the level of intrusiveness of the tax.[5]

Appropriate enforcement efforts are necessary to prevent non-compliance by both filers and non-filers. Insufficient efforts to keep the tax gap to a minimum result in inequities and inefficiencies due to the need to offset the revenue loss with other sources.

Accountability to Taxpayers

Accessibility and visibility of information on tax laws and their development, modification and purpose are necessary for taxpayers. Public awareness of tax reform activities, as well as an understanding of proposed changes, enables broader and more well-informed debate. Taxpayers should readily have access to information for understanding sources and uses of tax revenues. Transparency in the lawmaking and guidance process helps promote an improved understanding and respect for the system. Evaluating multiple alternatives before deciding on any particular change is necessary. Taxpayers should have opportunities through government reports and hearings to gain an understanding of the jurisdiction's tax and budget situation.

Appropriate Government Revenues

Tax systems should have appropriate levels of predictability, stability and reliability to enable the government to determine the timing and amount of tax collections. A dynamic and flexible tax system is necessary in order to adapt to changing needs and technological and commercial

[5] General Accounting Office (GAO), Reducing the Tax Gap – Results of a GAO-Sponsored Symposium, June 1995, GAO/GGD-95-157, page 13.

developments. It is important that a tax system is flexible to meet the current revenue needs of the government while adapting to changing needs on an ongoing basis. Thus, it is necessary to review tax systems regularly to ensure they are supportive of the jurisdiction's goals (or not hindering their attainment), appropriate for new business models, and capable of generating appropriate revenues.

Further, the complementary nature of a tax system among relevant jurisdictions is important. That is, giving consideration to how tax bases are determined within the national or global economy and the effect that changes in a tax system have on other tax systems is important. Consideration of fairness among jurisdictions is important, including revenue generation for the appropriate government for activities that involve multiple jurisdictions.

In order for required spending to occur, governments need assurance that tax revenues are available and stable. Tax revenues need to support general government spending needs, thus for example, earmarking tax revenues for a specific purpose warrants express justification. Regarding stable revenues, typically, a mix of taxes provides a more stable and flexible tax base because different types of taxes are affected differently by changes in the economy. For example, in an economic downturn causing unemployment, income tax revenues will decline. If the government is collecting other types of taxes that are less affected by decreased employment or if the effect will not occur as quickly, government revenues in total are less adversely affected than if the government relied solely on an income tax.

CHALLENGES

Various challenges exist to incorporating all of the guiding principles of good tax policy into any tax system. A number of these challenges stem from the desire to use the tax law for more than raising revenue, for instance, to implement social or economic policies (such as by limiting certain deductions and credits to individuals with income below specified amounts). In addition, frequent changes to the tax law challenge the principles of certainty and simplicity. The more changes that are made, the greater the difficulty taxpayers, practitioners, and government tax administrators have in understanding the tax consequences of transactions. Also, it becomes more difficult for tax agencies to issue guidance in a timely manner when there are hundreds of tax law changes every few years.

A key challenge is the reality that achievement of all of the principles is not possible to the same degree for all proposed tax changes. For example, to exclude a particular type of economic benefit from taxation may satisfy the simplicity principle, but not the equity or neutrality principles. Thus, lawmakers must carefully balance the guiding principles to achieve an optimal law.

CONCLUSION

A framework of appropriate tax principles is needed to analyze proposals to change tax rules and tax systems in order to best ensure an effective tax system based on good tax policy. The challenges that exist to incorporating the guiding principles of good tax policy are not insurmountable. It takes a concerted effort to consider these principles in any type of tax law change – both major and minor.

The AICPA encourages policymakers to work to improve our tax systems to better incorporate the principles outlined in this tax policy concept statement and will continue to offer its assistance in this important endeavor.

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